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No. 93-166

In The

Supreme Court of the United States

October Term, 1993

WALTER KILIMNIK and AEROSPACE & CORROSION INTERNATIONAL, INC., a Washington corporation,

Petitioners,

vs.

ZACHARY STOUMBOS, Trustee, as Successor to DALE W. WHITESIDES, Trustee,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

TRUSTEE'S BRIEF IN OPPOSITION

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TABLE OF CONTENTS

Page

I. *COUNTERSTATEMENT OF THE CASE* 1

A. Factual Background..... 1

B. The Law..... 3

II. *ARGUMENT*..... 4

A. There Is No "Split Between the Circuits," Because the Security Interest Issue Involves the Application of State Law 4

B. The Ninth Circuit Interpreted the Contract .. 6

C. The Ninth and Fifth Circuits Agree on the Elements of Equitable Subordination 7

III. *CONCLUSION*..... 10

TABLE OF AUTHORITIES

Page

CASES

Brockett v. Spokane Arcades, Inc., 472 U.S. 491 (1985) 6

City National Bank v. Chabot (In re Chabot), 992 F.2d 891 (9th Cir. 1993) 10

Haring v. Prosise, 462 U.S. 306 (1983) 5

NLRB v. Pittsburgh Steamship Co., 340 U.S. 498 (1951) 11

New York Times Co. v. Sullivan, 376 U.S. 254 (1964) 9

Ruhlin v. New York Life Ins. Co., 304 U.S. 202 (1938) 5

Stoumbos v. Kilimnik, 988 F.2d 949 (9th Cir. 1993) 1, 2, 4, 6, 7

Wilson v. Huffman (In re Missionary Baptist Foundation of America, Inc.), 712 F.2d 206 (5th Cir. 1983) 7

Zachary Stoumbos, the chapter 7 trustee of American Alloy Metals ("AAM" or "Debtor"), opposes the Petition for Writ of Certiorari ("Petition") filed by Walter Kilimnik and Aerospace & Corrosion International, Inc. (collectively, "Petitioners"). Petitioners present three questions for review. Of the three questions presented for review, the first two involve the interpretation and application of the law of the state of Washington and the third is a procedural issue relating to the application of the law of equitable subordination to the Findings of Fact entered by the trial judge. Petitioners' appeal does not involve the interpretation of the Constitution or of federal statutes. The questions which the Petitioners present for review are not appropriate for a writ of certiorari.

I.

COUNTERSTATEMENT OF THE CASE

A. Factual Background.

Although the Petitioners assert that "[t]he essential facts are simple," Petition at 1, the facts are more complicated than the Petitioners' two paragraph rendition would suggest. The trial court's Findings of Fact can be found in Appendix 4 of the Petition (pp. A-29 to A-37), and the Ninth Circuit's statement of facts can be found in *Stoumbos v. Kilimnik*, 988 F.2d 949, 952-53 (9th Cir. 1993). This case involves the conduct of an insider who purported to have a perfected security interest in all of the Debtor's assets.

What is missing from the Petitioners' "simple" rendition of the facts is the clear statement that Mr. Kilimnik

"was in sole control of AAM as president and holder of an irrevocable proxy to vote the shares," at the same time that he foreclosed on what he asserted to be his collateral. *Stoumbos*, 988 F.2d at 952-53. Mr. Kilimnik asserted his "rights" as a secured creditor while simultaneously serving as president and controlling person of the Debtor.

As the Ninth Circuit correctly pointed out, under Washington law Mr. Kilimnik had a fiduciary relation to AAM, and as a fiduciary he had a duty to protect "the entire community of interests in the corporation – creditors as well as the stockholders." *Stoumbos*, 988 F.2d at 959, *quoting*, *Pepper v. Litton*, 308 U.S. 295, 307, 60 S. Ct. 238, 84 L. Ed. 281 (1939). Mr. Kilimnik was a "insider" whose conduct is properly subject to "rigorous scrutiny." 988 F.2d at 959. The Ninth Circuit read the bankruptcy court's Findings of Fact and concluded that "Kilimnik's actions could not withstand this rigorous scrutiny." 988 F.2d at 959. As noted by the Ninth Circuit, the trial court expressly found:

> In foreclosing on his note, opening AAM Aerospace & Corrosion International and having Debtor renounce its interest in collateral, Kilimnik intended, if possible, to place his own interest, which he believed to be secured, ahead of the interests of Debtor's creditors.

988 F.2d at 959.

The Petitioners' "simple" statement of the facts is too simple.

B. The Law.

The Petitioners wrongly assert that the Ninth Circuit "made factual findings to the effect that Kilimnik did not have a perfected security interest in after-acquired assets." Petition at 2. The Ninth Circuit made no factual findings; the Ninth Circuit reversed the trial court on an issue of law. The question whether Kilimnik has a security interest in after-acquired assets required the court to interpret the parties' contract. As the Ninth Circuit correctly pointed out, "[i]nterpretation of a contract is an issue of law reviewed de novo." 988 F.2d at 954. The Ninth Circuit correctly applied Washington law governing security interests in after-acquired property, in motor vehicles, and in deposit accounts allegedly containing proceeds.

The Petitioners are especially misleading when they talk about "a split between several circuits on what language is necessary in a contract to give a creditor a security interest in after-acquired inventory." Petition at 2. Different circuits can differ on this issue because they are applying different state laws. The Ninth Circuit was applying Washington law. There is no "split between several circuits."

Finally, Petitioners object to the Ninth Circuit's reversal of the trial court's ruling that Kilimnik's claim should not be equitably subordinated. The Petitioners argue that "the bankruptcy court never made any factual findings on the elements of equitable subordination." Petition at 3. The Petitioners are wrong. The trial court made forty-five Findings of Fact in addition to the Admitted Facts in the Pre-trial Order. Petition, A-29 to A-49. The Ninth Circuit

applied the law of equitable subordination to "the bankruptcy court's own findings." 988 F.2d at 959. The Ninth Circuit concluded that the trial court's findings satisfied all three requirements for equitable subordination. 988 F.2d at 960.

II.

ARGUMENT

A. There Is No "Split Between the Circuits," Because the Security Interest Issue Involves the Application of State Law.

Petitioners erroneously assert that the "Ninth Circuit perpetuated a split between the circuits" when it held that the documents that gave Mr. Kilimnik a security interest in AAM's inventory, equipment and accounts receivable did not "automatically" give Mr. Kilimnik a security interest in "after-acquired" collateral. Petition at 4-8. There is no "split between the circuits," because none of the other circuits were interpreting the security agreement between AAM and Mr. Kilimnik or applying Washington law to that agreement.

The Ninth Circuit correctly saw its task to be the interpretation of the contract under Washington law. 988 F.2d at 954. "Interpretation of a contract is an issue of law reviewed de novo." 988 F.2d at 954.

> Under Washington law, the role of the court in a contract action 'is to ascertain the parties' intentions and give effect to their intentions.'

Stoumbos, 988 F.2d at 954, *quoting*, *Taylor-Edwards Warehouse v. Burlington Northern*, 715 F.2d 1330, 1334 (9th Cir. 1983), *quoting*, *In re Estate of Hollingsworth*, 88 Wn.2d 322, 560 P.2d 348, 350-51 (1977). The Ninth Circuit carefully analyzed the contract, and concluded that the Purchase Agreement limited the inventory collateral to "inventory . . . on hand at May 1, 1982," language that does not express an intent to include after-acquired inventory. 988 F.2d at 955-57. The Ninth Circuit's conclusion is correct.

The issue on appeal – whether Mr. Kilimnik's security interest in inventory and equipment extends to after-acquired inventory and equipment – is controlled by state law, specifically, Washington's law of contracts and Washington's version of Article Nine of the Uniform Commercial Code.

> As to questions controlled by state law, however, conflict among the circuits is not of itself a reason for granting a writ of certiorari. The conflict may be merely corollary to a permissible difference of opinion in the state courts.

Ruhlin v. New York Life Ins. Co., 304 U.S. 202, 206 (1938).

The security interest issue on appeal involves Washington state law, and does not merit a writ of certiorari. "[S]tanding alone, a challenge to state-law determinations by the Court of Appeals will rarely constitute an appropriate subject of this Court's review." *Haring v. Prosise*, 462 U.S. 306, 314 n.8 (1983). Normally, the Court defers to the construction of a state law given it by the lower federal courts for two reasons: (1) to avoid unnecessary review of their decisions, and (2) "to reflect our belief that district courts and courts of appeals are better

schooled in and more able to interpret the laws of their respective States." *Brockett v. Spokane Arcades, Inc.*, 472 U.S. 491, 500 (1985).

There are two sound reasons why the issue of the extent of Mr. Kilimnik's security interest is not appropriate for Supreme Court review. First, the Ninth Circuit correctly applied Washington's law of contracts and secured transactions to the facts of the case. Second, this appeal raises issues of state law rather than federal law.

B. The Ninth Circuit Interpreted the Contract.

The Petitioners complain that "[t]he Ninth Circuit exceeded its appellate jurisdiction by looking at extrinsic evidence to determine the intent of the parties to a contract, and making factual findings concerning that intent." Petition at 17. Petitioners overstate their case. The Ninth Circuit did not exceed its appellate jurisdiction.

The Ninth Circuit properly saw that its task on review was to interpret the parties' contract. "Interpretation of a contract is an issue of law reviewed de novo." *Stoumbos*, 988 F.2d at 954, *citing*, *Taylor-Edwards Warehouse v. Burlington Northern*, 715 F.2d 1330, 1333 (9th Cir. 1983) (applying Washington law). The Ninth Circuit read the Purchase Agreement and concluded that it did "not support a holding that Kilimnik had a secured interest in equipment and inventory acquired after May 1, 1982." *Stoumbos*, 988 F.2d at 954. It reached this conclusion after observing:

> The Purchase Agreement makes no reference to "after-acquired" equipment or inventory, although it does use "after-acquired" language with respect to accounts receivable.

988 F.2d at 954.

The Ninth Circuit did not "exceed its appellate jurisdiction." It interpreted the contract.

C. The Ninth and Fifth Circuits Agree on the Elements of Equitable Subordination.

The Ninth Circuit and the Fifth Circuit agree on the three essential elements of an equitable subordination action:

(1) the claimant has engaged in inequitable conduct,

(2) the claimant's misconduct resulted in injury to competing claimants or an unfair advantage to the claimant; and

(3) subordination is not inconsistent with the Bankruptcy Code. *Stoumbos*, 988 F.2d at 958; *Wilson v. Huffman (In re Missionary Baptist Foundation of America, Inc.)*, 712 F.2d 206, 212 (5th Cir. 1983).

The Petitioners argue that the Ninth and the Fifth Circuits, while agreeing on the essential elements of an equitable subordination claim, are split on whether an appellate court can take the factual findings of the bankruptcy court and reach a different legal conclusion on the issue of equitable subordination. The Petitioners point out that the Fifth Circuit requires bankruptcy courts to make explicit findings of fact on each of the three elements of equitable subordination. Petition at 18. The

Ninth Circuit does not expressly require the trial court's findings to address explicitly each of the three elements. In *Stoumbos* it was sufficient that when the Ninth Circuit applied the correct legal standard to the bankruptcy court's findings, the court could conclude that all three elements of an equitable subordination action had been satisfied and that Kilimnik's claim should be equitably subordinated.

Petitioners indulge in hyperbole when they assert:

> The Ninth Circuit created a split between the Ninth and Fifth Circuit Courts of Appeals concerning an appellate court's jurisdiction to use findings of fact entered for one cause of action in support of granting positive relief under a completely different cause of action. If this holding is allowed to stand, it creates a dangerous precedent for appellate courts which wish to conduct a trial without involving the trial court, merely by adapting findings of fact to the elements of causes of action the trial court never considered in reviewing the evidence.

Petition at 22. There is no split of the circuits "concerning an appellate court's jurisdiction." At most the difference between the Ninth Circuit and the Fifth Circuit is that the Ninth Circuit will apply the law of equitable subordination to the bankruptcy court's findings of fact even if the bankruptcy court did not explicitly address each element of the three-part test and the Fifth Circuit requires that findings of fact in equitable subordination cases explicitly address each element of the three-part test separately.

Nor does *Stoumbos* create "a dangerous precedent for appellate courts which wish to conduct a trial without

involving the trial court." Petition at 22. Petitioners offer no reason for their assertion that *Stoumbos* creates "a dangerous precedent." There is no indication in the opinion that the Ninth Circuit "wish[ed] to conduct a trial without involving the trial court." The Ninth Circuit applied the correct legal standard to the facts in the trial court record.

Appellate courts do not exceed their jurisdiction when they apply the correct legal standard to the facts in the trial court record. For example, in *New York Times Co. v. Sullivan*, this Court announced the correct legal standard, applied that standard to the evidence in the record, concluded that the evidence was insufficient to support the trial court's judgment, and reversed. 376 U.S. 254, 292 (1964). In *Stoumbos*, the Ninth Circuit did no more.

In *Stoumbos*, the Ninth Circuit concluded that the bankruptcy court's legal analysis was flawed. The bankruptcy court failed to apply the "rigorous scrutiny" appropriate to the actions of insiders. 988 F.2d at 959. The bankruptcy court also committed errors of law by focusing on injury to "creditors as a whole" rather than inquiring "whether Kilimnik's self-dealing resulted in 'injury to competing claimants or an unfair advantage' to Kilimnik himself." 988 F.2d at 960. Using "the bankruptcy court's own findings," and applying the correct level of scrutiny, the Ninth Circuit concluded that the three elements of an equitable subordination case had been satisfied. *Stoumbos*, 988 F.2d at 959-60. The Ninth Circuit reversed the trial court on the legal issue of equitable subordination and remanded the case so that the bankruptcy court could "determine to which claims Kilimnik's claim

should be subordinated, and to what extent." 988 F.2d at 961.

Petitioners claim that the Ninth Circuit exceeded its jurisdiction by reversing the bankruptcy court on the issue of equitable subordination rather than simply remanding the case to the bankruptcy court "with instructions to make factual findings under each of the elements of equitable subordination." Petition at 21. The Ninth Circuit did not err. Conclusions of law are reviewed de novo. *City National Bank v. Chabot (In re Chabot)*, 992 F.2d 891, 893 (9th Cir. 1993). The Ninth Circuit applied the correct legal standard to the bankruptcy court's findings of fact, and decided that the bankruptcy court's conclusion of law on the issue of equitable subordination was erroneous. In so doing, the Ninth Circuit properly carried out its role as an appellate court.

III.

CONCLUSION

None of the Petitioners' three questions presented for review deals with issues of sufficient federal importance to merit a writ of certiorari. The first two issues – whether a security interest in inventory automatically extends to after-acquired inventory and whether it was appropriate to consider extrinsic evidence to determine the intent of the parties to a contract – are state law issues. The third issue – whether the Ninth Circuit should have remanded for explicit findings of fact rather than applying the correct legal standard to the bankruptcy court's findings of fact and reversing – is a matter of importance to the

parties but not one of sufficient national importance to merit a writ of certiorari.

> Certiorari is granted only "in cases involving principles the settlement of which is of importance to the public as distinguished from that of the parties, and in cases where there is a real and embarrassing conflict of opinion and authority between the circuit courts of appeal."

NLRB v. Pittsburgh Steamship Co., 340 U.S. 498, 502 (1951), *quoting, Layne & Bowler Corp. v. Western Well Works, Inc.*, 261 U.S. 387, 393 (1923). *Kilimnik v. Stoumbos* is not a case "involving principles the settlement of which is of importance to the public." Nor is it a case "where there is a real and embarrassing conflict of opinion and authority between the circuit courts of appeal." This case does not merit a writ of certiorari.

The Trustee requests that the Petition for a Writ of Certiorari be denied.

RESPECTFULLY SUBMITTED this 26th day of August, 1993.

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